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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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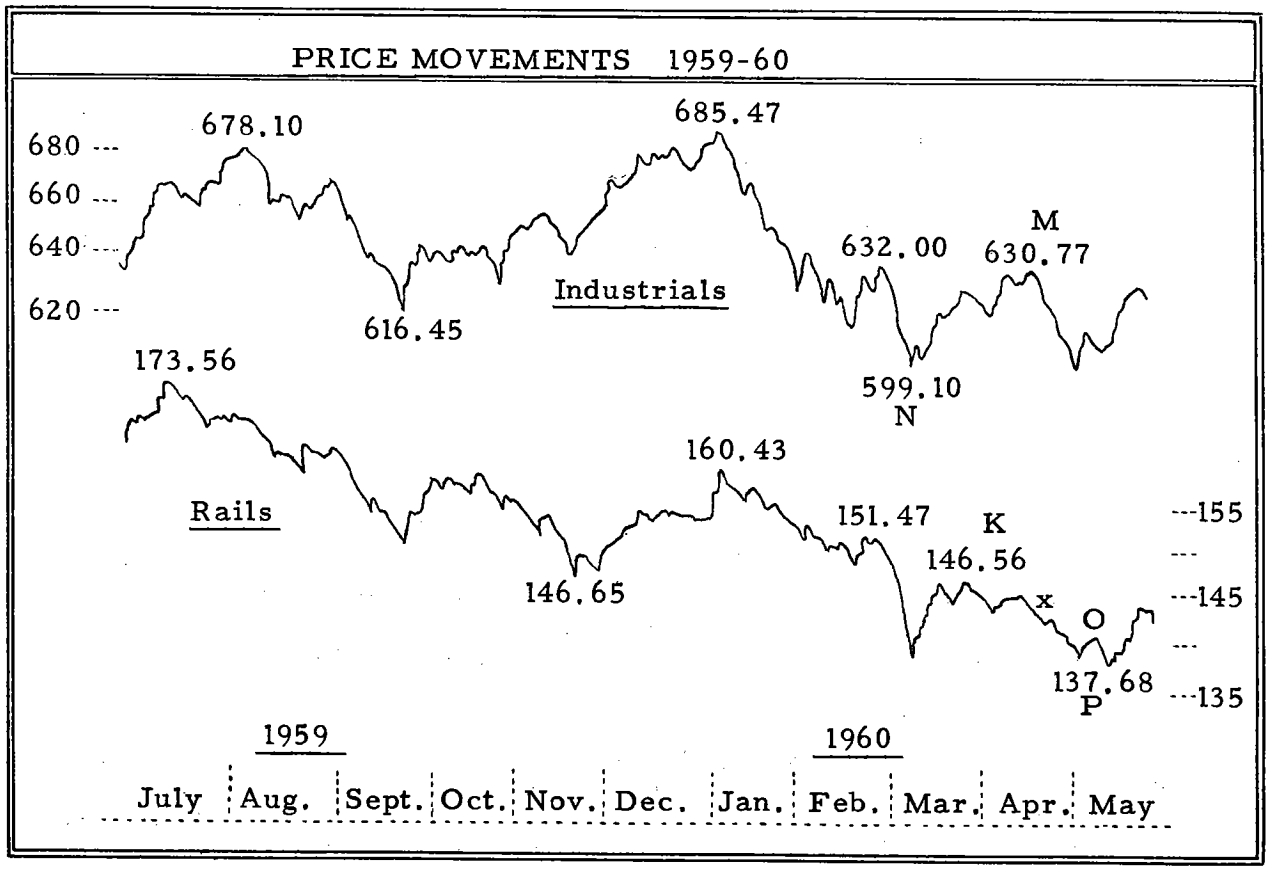
MARKET. In presenting his discussion of the price movement in Barron's and the Wall Street Journal, Hamilton possessed a great advantage over this and other "sooth-sayers" in that he did not have to write with any sort or regularity. There are often extended periods when the Averages are unclear or absolutely noncommittal. During those times I generally find myself wishing that I could be spared the task of writing a Letter. Hamilton was well aware that the Averages are not always predicting, and he often reminded readers of that fact. Thus he wrote on December 8, 1913, "From the point of view of the Averages, nothing very striking is to be gleaned." Again on January 5, 1914, Hamilton admits, "Not much information could be derived from the fluctuations of the Averages last week." In December, 1925 he observed, "The Dow Jones Averages have a discretion not shared by all prophets; they are not talking all the time."

In the current market, taking the movements from the March 8 lows to the present, it is clear that the Averages have not yet rendered their decision as to the direction of the secondary trend. A bettering of the previous secondary highs (Industrials at M - 630.77, Rails at K - 146.56) would signify a full resumption of the secondary (upward) trend. Conversely, a cracking of the bear market lows (Industrials at N - 599.10, Rails at P - 137.68) would indicate that the secondary trend is down. The primary trend or great tide of the market is bearish and has been since July 8, 1959.



At varying intervals, particularly after the market has been buffetted by big black newspaper headlines, it is well to step back and try to grasp the larger picture. When the "news winds" are blowing, the ripples and the spray often obscure the main direction of the tide.

On July 8 the two Averages established their last confirmed highs of the bull market's third phase. Following a further Industrial peak of 678.10 (unconfirmed by Rails), a reaction occurred. This reaction terminated for Industrials in September (616.45), for Rails in November (146.65).

During the months of October and November the two Averages got badly "out-of-gear", a phenomenon which suggested opposing forces in production and shipping. Such extended periods of divergence often warn of forthcoming primary reversals.

Following the divergence, Industrials (on January 5, 1960) established a new bull market high of 685.47; Rails refused by the wide margin of 13 points to confirm. In retrospect we know that a good part of the December-early January buying was prompted by the widely-held opinion that an ending of the steel strike would mean new highs for the economy. Informed investors, sensing the turn, utilized that psychology to unload. The record Industrial high of January 5 was, in fact, recorded a few days after the actual news of the steel settlement.

Immediately following the 685.47 high, the market went into another steep reaction, which by March 3 had succeeded in taking both Averages below their previous September-November levels. Under Dow Theory, a primary bear market had been confirmed.

The big picture, then, is this -- we see a peak on the Industrial Average in July, 1959, another in January, 1960, with Rails refusing to confirm the second Industrial peak. Such a structure, as far as Dow Theorists are concerned, contains classic elements of danger. Obviously, the pattern was one of non-confirmation, with Rails being the laggards and providing the danger signals.

The secondary pattern, as it has developed since the end of February, 1960, could be forming a "miniature" of the entire 1959-60 movement. At the end of February, Industrials hit a high of 632.00; Rails were 151.47. The next peak for Industrials was 630.77 (April), with Rails at 146.56. More recently Industrials have again entered the 625-32 area, with Rails confirming only in a minor sense (above points O and x) but still well under their more important secondary peak of 146.56.

The question now is -- will the pattern which appeared during 1959-60 repeat itself? From a Dow Theory standpoint we should be watching to see if Rails refuse to better 146.56 on any further Industrial strength. The classic non-confirmation pattern (with Rails, so far, acting as the weaker Average) has served to warn of every decline since July, 1959.

QUESTION "In your last Letter you stated that a rail bettering first of point O, then of point x, could provide enough technical strength to take Industrials to or above their April high at M. Last week Rails did better O and x and Industrials did approach point M. But in view of three or four Rail mergers announced very recently, couldn't the Rail strength reflect the changed status of those stocks rather than any forthcoming expansion in shipping and transportation?"

ANSWER The rash of Rail mergers definitely could be reflected in the Rail Average, and probably that has happened to some extent. Nevertheless, it would take a movement of both Averages over their previous secondary highs (Rails at K, Industrials at M) to signal a continuance of the secondary uptrend in a full Dow Theory sense. As of this

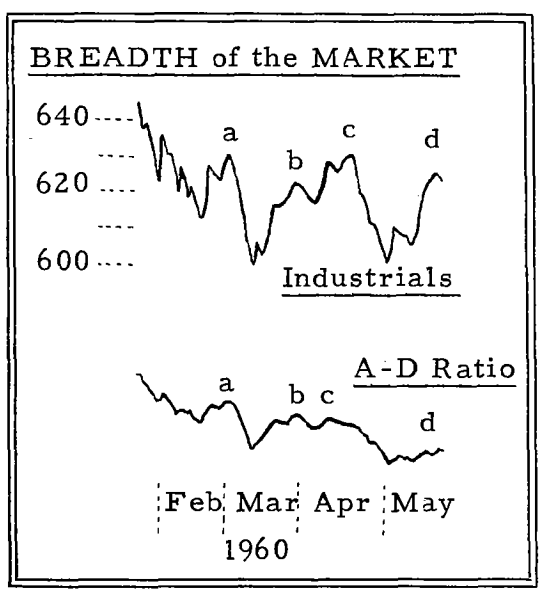
writing, the two Averages have succeeded only in bettering minor points in the secondary structure. I believe it will take something more fundamental than merger news to get Rails over point K (146.56).

SUBSCRIBERS. The circulation of these Letters, judging from correspondence received over the last year, seems to be growing steadily among banking, corporate and sophisticated investing circles. All this, of course, makes my job a good deal easier. Conversely, subscriptions from "tip-seekers" and "scalpers" are gradually dropping off. This too is all to the good, the more so since I do not see how these Letters can be of the slightest use to market gamblers who spend their days watching the tape or searching for new ways of "beating the market".

Moreover, I have a rather selfish reason for preferring intelligent clients, and it is this: when a bear market arrives it is usually not too long before the gambling element goes "broke", and their interest in the market drops as quickly as their bank balance. Intelligent investors, on the other hand, have a habit of staying solvent during economic reversals And since the latter will be watching (along with this writer) for the beginning of the next bull market, their interest in Dow's Theory should remain as strong as ever.

A physician from Kansas City (who happens to be an excellent market student) has sent me a copy of a weekly letter which he writes in order to educate himself, his family and his broker. He and his young son keep charts of the Averages (a "must" for every market student) together with graphs of the different technical indices and a series of notes which they call "Market Musings". Of his letter, the doctor writes, "I am in a very enviable position. No one is seeking my advice, and my opinion is being sought by only two other people. No one is constantly needling me about the minor fluctuations in the market. The only explosions I have heard are from my wife and Jim when I tried to miss a week of the 'Musings' at a time when I felt that the Averages were not saying a thing. Best of all, no one is asking me what to buy or what to sell short. However, remember that I also deal with the public; their money and health are very dear to them. You deal with one, and I deal with the other."

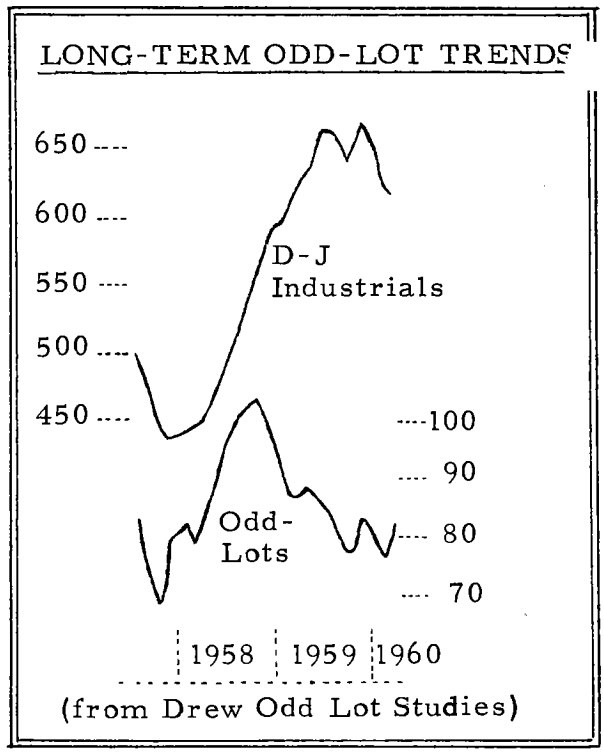
TECHNICAL REVIEW The advance-decline ratio ("breadth of the market") presents a picture of successively lower peaks. The poor showing of the general market, although obvious on the A-D ratio, is probably best known to investors who have held diversified portfolios over the last year. During that time the market has shown sporadic strength in a diminishing number of groups, with other groups sinking to new lows. Perhaps the process can best be described as revolving weakness. Note that the breadth (see chart) hit a minor peak (a) in February, which corresponded with the Industrial rally to 632.00. Two lower peaks (b and c) were touched in April on the Industrial rally to 630.77. On the most recent rally (d) from the March 8 lows, breadth has again refused to expand. This is an element of obvious weakness in the market at this time.



The odd-lot picture on a long-term basis (chart shows three-month moving average of monthly odd-lot totals) indicates that the odd-lot (under 100 share) balances are still well into the "buy" side of the ledger. Anything over 100 on the chart represents odd-lot selling on balance, while figures under 100 show odd-lot buying on balance. A ratio of 80, for instance, is equal to five shares bought for every four sold.

On a short-term basis the odd-lots are more difficult to interpret, but the most recent action (not shown here)

indicates a good measure of caution on the part of the odd-lotters. Ratios over the past few weeks have been in the 85-97 area, and this has been reflected in the recent firmness of the market. Often, however, odd-lot ratios will show caution at a rally peak, only to turn increasingly bullish as an important decline gets underway. This type of action has been apparent at a number of recent peaks and can prove most deceptive.



The short interest - average daily volume ratio has been holding in a narrow range. The May 15 reading, despite a 5.1% increase in the short interest between April 15 and May 15, actually dropped from 1.19 to 1.13. This decrease in the ratio, of course, reflects increased volume during the period, but it also invalidates any bullish conclusions which might have been drawn from the increase in the short interest.

CURRENT PRICE MOVEMENTS Despite much "sound and fury", the price action over the last few weeks has been inconclusive. Explosive volume (see chart) followed the Summit collapse, but despite the volume neither Average bettered their March-April secondary highs. As the rally to R progressed, volume trailed off with Industrials hitting a minor peak at R (625.24), Rails at R (143.91). A joint bettering of these points would suggest a further assault on the March-April highs. Rails, however, have fromed a tiny downward zig-zag so that they now look weaker than stronger. An Industrial bettering of R without Rail confirmation could be potentially dangerous. Exactly this type of action has tipped every selling spree since last year.

QUESTION "I sold out last August as you suggested, and I have captured many good profits. But suppose this is a two or three year bear market? I do not particularly like the short side and do not seem to have the temperament for it. What does someone like me do during a long bear market?"

ANSWER Conserve your capital and learn all you can about stocks and price movements. In so doing you will be preparing for the next bull market. Those who hold cash are speculating on the purchasing power of the dollar. During bear markets, the purchasing power of the dollar usually increases.

(Written Thursday, May 26, before the close)